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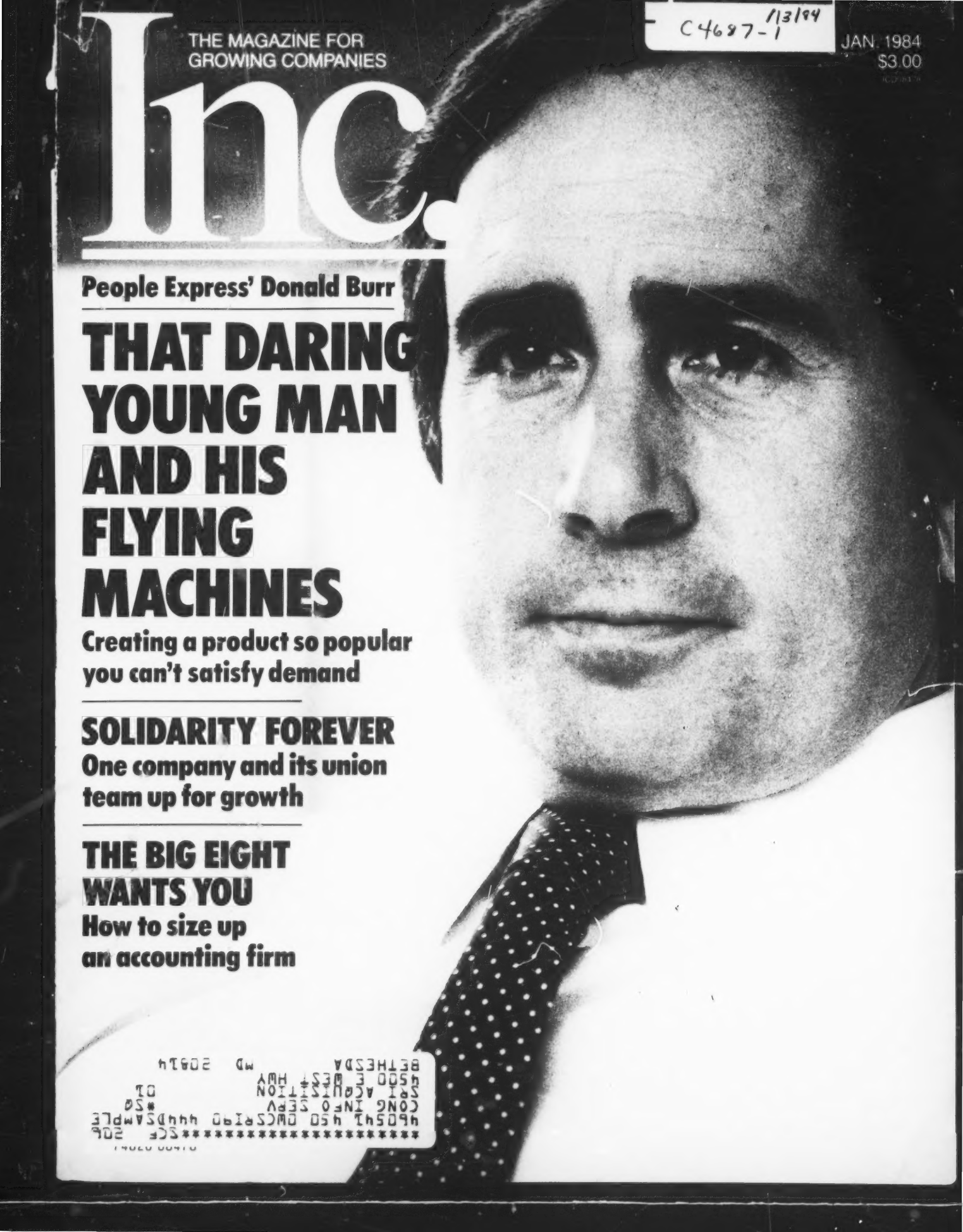

People Express' Donald Burr

THAT DARING YOUNG MAN AND HIS FLYING MACHINES

Creating a product so popular you can't satisfy demand

SOLIDARITY FOREVER

One company and its union team up for growth

THE BIG EIGHT WANTS YOU

How to size up an accounting firm

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INC. Cover Story

THAT DARING YOUNG MAN AND HIS FLYING MACHINES

The fastest-growing company in the history of aviation has a problem. It has designed a product so popular that it can't satisfy demand.

By Lucien Rhodes

Candee Brock is being cross-utilized today.

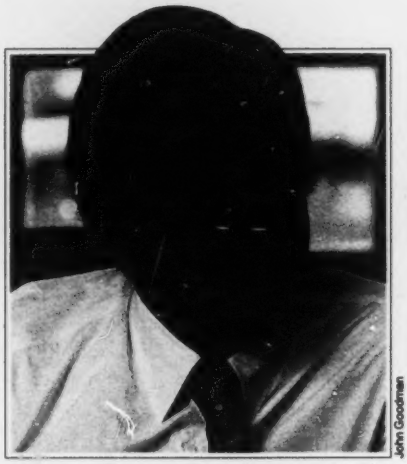
Wearing the brown and tan uniform of People Express Airlines Inc., she is checking bags for passengers leaving the North Terminal of Newark International Airport. Between tickets she talks about a day that changed her life.

March 25, 1981, was an unusually pleasant day in Buffalo, after a harsh, lingering winter. Candee thought she had things pretty well figured out. She had just quit her job as a dental hygienist and was enrolled to study business management at State University College at Buffalo. She was at home reading the *Buffalo Courier-Express* and saw an ad announcing great opportunities as a customer-service manager for People Express. "It seemed like it was written just for me," she says.

Candee drove to the Sheraton Inn Buffalo East, where the interviews were being held, took a look at the mob of some 12,000 applicants, and drove back home. "They'll never notice me in all those people," she recalls thinking. She considered doing some studying or maybe some errands around the neighborhood, but the ad wouldn't leave her alone. She drove back to the interviews.

On April 2, Candee arrived in Newark, N.J., and checked into the Holiday Inn North, where she would live for a month while she was in training. "When I first got to the People Express office," she says, "I found an empty terminal with garbage cans lying around. There were no planes; you had to imagine them flying in. I said to myself, 'We're going to land people here?' But a month later, I was at the check-in counter. The garbage was gone, the planes were here, and there was wallpaper on the walls, even if it was still wet."

When she is not checking baggage, Candee is team manager for 54 people in the accounts-payable and accounts-receivable



John Goodman

section of the accounting department. She works 10 to 12 hours a day, five or six days a week, and says she would work more. She makes $24,000 a year and owns 8,400 shares of People Express stock, trading over-the-counter at $18.50 a share at press time. Candee is 25.

"I've grown a lot in two years," she says. "My job has given me more confidence in every area of my life. Now I'm involved in the day-to-day operations of a very successful airline."

Indeed, "very successful" may beggar the truth. By all accounts, People Express is, quite simply, the fastest-growing airline in the history of aviation, a happy fact that flight attendants will sometimes announce at the end of a flight. Says John J. Dickerson Jr., general manager of New Jersey airports: "Fantastic is even an understatement. Their growth is a phenomenon all its own."

In one furious acceleration akin to the lift-off thrust of a Boeing 737, People Express rose, in just two and a half years, from relative obscurity to international prominence. From 250 to more than 3,000 full- and part-time employees. From three planes serving 3 cities with 24 flights a day to a fleet of 22 Boeing 737s, 10 Boeing 727s, and one 747 making 264 nonstop flights daily to 20 destinations, including London. From a loss of $9.2 million, including start-up costs, on $38.4 million in revenues to earnings of $1 million on revenues of $138.7 million in 1982. And the company recently reported revenues of $116 million and net income of $6.3 million for the first six months of 1983. People Express has carried some 10 million passengers and is currently the largest single airport operation in the New York metropolitan area.

And it has done all this despite a severe economic recession, withering price wars, a national air-traffic-controllers strike, and otherwise dismal conditions in the airline industry that have included bankruptcies and widespread operating losses.

"We have a unique problem," president and founder Donald Burr recently told a group of college educators. "We've designed a product which is so popular we can't satisfy the demand for it."

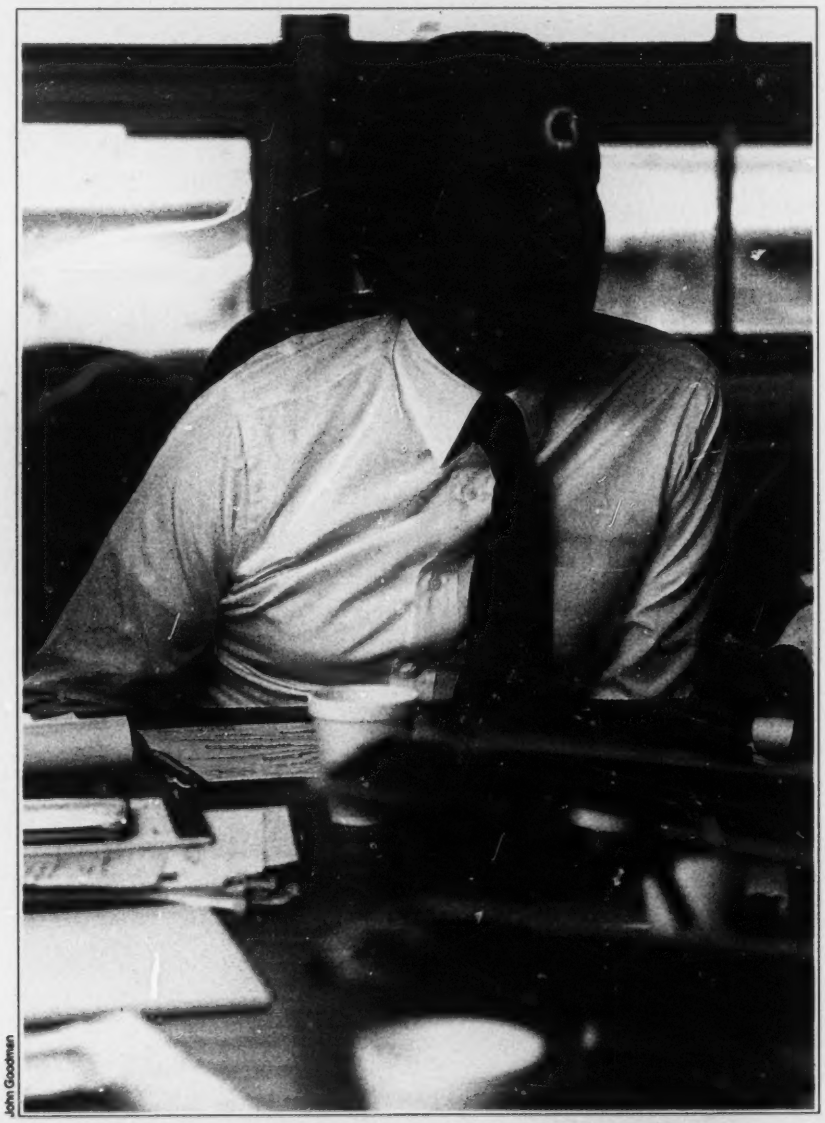
That product is a seat on an aircraft that flies between Newark and some other major city on the East Coast (and London), that is frequently available, and that is, above all, cheap. For example, the well-known Eastern Air Lines Inc. Shuttle between New York and Boston offers 15 flights a day during the week for $57 during peak hours and $42 off peak. The People Express shuttle between Newark and Boston offers 20 flights a day for $38 peak and $25 off peak. People Express passengers are ticketed on board or pay in advance through a travel agent. They pay to have baggage checked and for snacks and drinks on board. There are no free magazines, either. The most telling measure of

CEO Donald Burr (above, and center right with some of his team members): "People are the glory and frustration of People Express."

the popularity of the Spartan treatment is called the "load factor." The load factor expresses with a percentage that portion of all available seats in any given time period that were actually filled by paying customers. In July, People Express's load factor was a stunning 83.6%, compared to an average load factor of 60% for the airline industry. "We believe," Burr says, "that if you respect people and give them a good deal, they'll use the hell out of it."

But Burr also says, "Being a commercial success is not enough. It's a derivative of doing other things well. The whole purpose of creating this enterprise in the first place was to create an environment which would enable and empower employees to release their creative energies." For Burr, the interplay of marketing, scheduling, and cost control has a beauty all its own, but the personal fulfillment of individual employees through the company's "people structure" offers something more. "People," he says, "are the glory and frustration of People Express."

Sometime during his childhood in South Windsor, Conn., Don Burr, now 42, discovered three truths about himself that he would pursue for the rest of his life. Whenever he did something he liked, Burr noticed, he invariably did well at it. And, resting on the same ledge of raw self-awareness, he found two other items of interest. For one thing, he liked planes. Every Sunday he badgered his parents into driving him to Hartford/Brainard Airport. There he would lose himself in the wide-eyed splendor of man-made flight. For another, he liked business.



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"This is capitalism," says Burr. "People are getting rich here. There are millionaires here and 25-year-olds worth $75,000, $100,000, $200,000. Tons of 'em."

"I used to go into the candy store," he says, "and wonder how that guy ran that store. I thought I could never do that—run a store, order all those things. Kids would talk about Mickey Mantle hitting home runs. I thought that was great how that guy ran that store. I've always been like that. I've always wanted to know how you put those things together."

After graduating from Harvard Business School in 1965, Burr became a securities analyst for National Aviation Corp., a closed-end investment company based in New York City that specializes in airline and aerospace securities and venture capital. Six years later, he was elected president of the company. At 31, Burr was already an expert in the economics and financial strategies of starting and running a commercial airline.

One of the airlines in the National Aviation portfolio was Houston-based Texas International Airlines Inc., a regional-service airline that, according to Burr, had a long history of mismanagement and had a huge working-capital deficit. Texas International asked Burr if he would help bail it out, and he accepted. Burr was getting closer to his own candy store.

Burr's careful study of the airline industry as a securities analyst didn't fail him. He recalled that during the early 1960s, Pacific Southwest Airlines in California had used low-price fares as a marketing strategy to increase traffic. In 1976, Burr, faced with a similar problem, dusted off the idea, dressed it up a bit, and introduced "Mr. Peanut" as the embodiment of Texas International's new, low-cost "peanuts fares" between selected cities. "There were lots of arguments inside Texas International about peanuts fares," remembers Burr, "and somebody told me later that they burned Mr. Peanut in effigy."

But the plan worked. As traffic rose so did profits, and so did Burr. In 1976, he was made chief operating officer and in June 1979, president. Six months later, he resigned. Mr. Peanut would soon find a new identity in Newark.

When Burr left Texas International, he had no specific direction in mind. Congress had passed the Airline Deregulation Act of 1978, which freed existing airlines to compete aggressively in both route selection and pricing, and encouraged new entrants. Burr sensed that the end of 40 years of control by the Civil Aeronautics Board (CAB) created an historic moment exactly when he was looking for a new challenge. At the same time, he was disturbed by a kind of free-floating, and growing, dissatisfaction with what he viewed as typical corporate attitudes toward employees. "Most organizations frustrate people who really want to work," he says. "They

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Cross-utilization in action: Candee Brock, a team manager in accounting, aids arriving passengers.

control them, and watch them, and check up on them. They subsume the individual. They consider them guilty until proven innocent."

At first, he waited for greatness to be thrust upon him. After all, he was only 38 and he had already been president of two companies. He was well known in the industry and well connected on Wall Street. "I was thinking that I'll get some calls for sure. There must be a lot of people out there who want somebody like me to run their airlines. But did I get any substantive calls? My mother called and that's pretty much it. That's when I realized that the world really didn't care whether I got up in the morning, it didn't give a damn. But is that bad, is that immoral? No, that's life. That's the way it is. No one would have me, so I had to start my own.'"

When friends or business associates talk about Donald Burr today, they invariably say, "He could've been a preacher." They don't say "minister," or "reverend," or "clergy." They say "preacher" because it conveys exactly the right sense of sweating-in-a-hot-tent, evangelical fervor that makes the pulse race. Burr works hard when he talks. He paces, he sits, he stands, he throws out his arms, he condemns and praises, implores and jokes. He moves effortlessly from the blunt, almost slang, of a working-class neighborhood to the polished diction of the corporate boardroom. And all the while, there never seems to be any doubt that he can do exactly what he says he will.

Little wonder, then, that Gerald L. Gitner, his senior vice-president of planning and marketing at Texas International, and Melrose Dawsey, Burr's executive assistant, both risked their careers by resigning a day after Burr. They didn't know what they could earn, if anything, or what they would do, but it didn't matter. Burr had set out on a great adventure and they wanted to go along.

This band of fellow travelers that Burr remembers as "three lonely people standing on a street corner" soon moved inside when they took space in a "rent-an-office place of the type used by fly-by-nighters" in Houston. During the day, they read trade journals and made calls to friends in the airline industry, trying to unearth an appropriate opportunity for themselves. Between calls, they passed the time by daydreaming out loud about starting a new airline: If you could, how would you organize it? Where would you get the money? What kinds of planes would you use? What airports, and, wouldn't it be nice? Then one day, imperceptibly, daydreaming turned to planning and commitment. It would be a candy store on a grand scale. Burr sold off his car, his house, two condominiums in Park City, Utah, and one in Vermont, his Texas International stock, and he drained his savings so he could put $350,000 into the new venture. Gitner invested $175,000, and Dawsey, $20,000. On April 7, 1980, they incorporated People Express, a new commercial airline whose very name, in Burr's opinion, put first things first.

The next year was a breathless, nonstop, near-miracle of activity: raising money, finding planes, finding an airport, preparing documents, recruiting and training personnel, selecting routes, and working out schedules. Three people could never have done it, but, as Burr spread the word, more of his Texas International colleagues began signing up. There was Harold "Hap" Pareti, 35, his former legal counsel, now managing officer for flight operations and legal and government affairs; Lori Dubose, 31, managing officer who is in charge of recruitment and training and in-flight service; and Bob McAdoo, 38, his former controller and now chief financial officer. By December of 1980, some 15 former Texas International executives and managers had joined the People Express start-up team, and Burr, at 39, was the oldest member.

In July, People Express became the first airline to apply to the CAB for permission to form a new airline since the passage of the 1978 Airline Deregulation Act. Although the 200-page required document filed with the CAB stated that the company intended to raise roughly $5 million and lease a few planes to fly out of Newark until it had made enough money to buy

John Goodman

People Express is traveling in uncharted territory, says one consultant. "Other firms have done parts of what they're doing, but the complete package is unique."

planes, Burr had already begun work on a larger concept.

People Express chose to fly its planes in a configuration known as the "hub and spoke." All flights would make round trips between a single point (the "spokes") and a single terminal (the "hub"). "Among other advantages," Burr says, "a good hub-and-spoke operation is like a fortress because you can control the traffic at that terminal and shut out competition." But with only three leased planes as outlined to the CAB, People Express could hardly boast of being impregnable. Burr wanted to establish a large and immediate presence in the marketplace, and it would cost a lot more than $5 million. Fortunately, in August 1980, Bill Hambrecht of Hambrecht & Quist, the San Francisco–based investment firm, took Burr to lunch at the University Club in New York City.

Hambrecht was eager to meet Don Burr. He had heard about Burr's plans through a mutual friend and had already done some research on his own. Burr, on his side, intended to ask Hambrecht to take People Express public immediately even though no airline had ever gone public to raise start-up money. They lunched amiably for about 45 minutes, swapping stories about finance and Wall Street. Then Hambrecht announced that he had to leave for an appointment, and Burr choked on his food. "I was horrified," Burr says. "We'd been doing all this talking, and I hadn't even described my proposal. So I blurted it out. He asked me a few questions and agreed. I nearly fell off my chair." Says Hambrecht, "The whole thing made a lot of sense to me—fast turnaround, low fares. I've always felt that in a climate of deregulation, low-cost newcomers have a great opportunity because the old companies usually hate to give away their price monopoly; they're slow to adjust to the new competition." Burr was ecstatic. "When I walked out of there," he says, "I could've touched the moon."

Later that month, Burr showed up at Newark International Airport for the first time. Although Burr had designated Newark as the People Express airport, he had only read that space was available; the actual details were far from certain. "I didn't know Newark from my elbow," he says. "Actually, I kinda liked San Francisco."

John J. Dickerson Jr., the general manager of New Jersey airports, had already heard the story many times before Burr ever knocked on his door. Deregulation had spawned a small army of would-be airline operators. Some had only great ambitions and never showed up, but some had great ambitions and planes and never showed up. "We were almost going to put up a scorecard," Dickerson says. One operator had even gotten so far as to move into the office Burr now occupies. He went bust so fast that he left his furniture behind.

Dickerson explained that the first airport terminal constructed by the Port Authority of New York and New Jersey, the North Terminal, had been largely vacant since 1973, when the airlines quartered there moved to two newly built terminals. When he saw it, Burr's normal effervescence temporarily went flat. "It was a ghost town," he says. "What didn't fall on your head bit you in the ankle." But it was right in the heart of the brisk airline traffic of the New York/Newark metropolitan area. Burr said he would take it.

No sooner had Burr left Dickerson's office than he was hit by a crushing anxiety attack, and he rushed to a phone booth to call Bill Hambrecht. "I know it was foolish," Burr says, "but everything hit me all at once. There I was at Newark airport renting space. I mean, I was really starting an airline. I guess I panicked about the money." "We shook hands," Hambrecht told him. "We'll do our best."

On October 24, 1980, the CAB granted People Express its certificate to operate as an interstate airline. A few weeks later, the company received approximately $24 million from the successful Hambrecht & Quist financing of 3 million shares at $8.50 a share. The timing couldn't have been better. Burr had just read in a trade journal that Lufthansa, the German airline, wanted to sell a fleet of 22 used Boeing 737s, and he immediately sent Hap Pareti to Frankfurt to negotiate terms. Pareti got 17 of the planes for around $70 million, or $4.1 million per plane, at a time when a new, deluxe Boeing 737 cost as much as $13 million. Lufthansa also agreed to repaint and remodel the planes according to People Express specifications. According to the terms of the agreement, People Express would lose a mandatory $6-million deposit if, for any reason, it failed to take delivery of any one of the planes. "When we got the Hambrecht financing and the 17 planes," Burr says, "I knew the sky was the limit."

Members of the start-up team spent their last night in Houston on New Year's Eve, which they celebrated by holding a long meeting on compensation policies. Then the great exodus to Newark began in earnest. By January 7, 1981, the crew members had checked into the Howard Johnson Motor Lodge near the airport, where most of them would live for the next eight months. The next day, everyone drove over to the new corporate headquarters. It was a cold and dreary day, and life at the office wasn't very plush.

Not much had changed since Burr first walked the grounds with Dickerson. Don Hoydu, a managing officer who served as an advance-man for the group, had managed to furnish a small, second-story corner of the terminal with telephones and a few desks and chairs. The group's christening act was the immediate purchase of several portable heaters to supply that which the building lacked. Then they turned their attention to the rest of the terminal. George Rayl, 35, the third pilot hired by the company, remembers the scene well: "Somebody moved out of there seven years earlier, and they were in a big hurry. There were boxes and junk all over and people running around everywhere. It took two days just to scrape the dirt off the windows.

On April 30, 1981, three Boeing 737s

HOW PEOPLE DOES IT

"Give people a good deal," People Express founder Donald Burr says, "and they'll use the hell out of it." Expressed as "revenues per passenger mile," the company's ticket prices are far below those of its four major competitors. As a result, People Express fills more seats on any given plane as illustrated by the "load factor" percentage. The secret lies in controlling costs. People Express's "operating expenses per available seat mile," the basic measure of costs, are the lowest in the airline industry, so it can maintain its deep discount pricing.

Research assistance was provided by Maura McEnaney.

Operating expenses per available seat mile

	1982	1st 6 mo. of 1983
Delta	7.97¢	8.11¢
Eastern	8.21	8.42
Piedmont	9.26	8.91
US Air	11.07	10.64
People Express	5.00	5.60

Revenue per passenger mile, or "yield"

Delta	13.67¢	12.03¢
Eastern	13.01	12.39
Piedmont	15.87	15.29
US Air	19.51	17.69
People Express	8.90	8.00

Load factor

Delta	52.7%	58.3%
Eastern	56.7	60.9
Piedmont	55.6	59.5
US Air	57.2	60.5
People Express	60.9	77.5

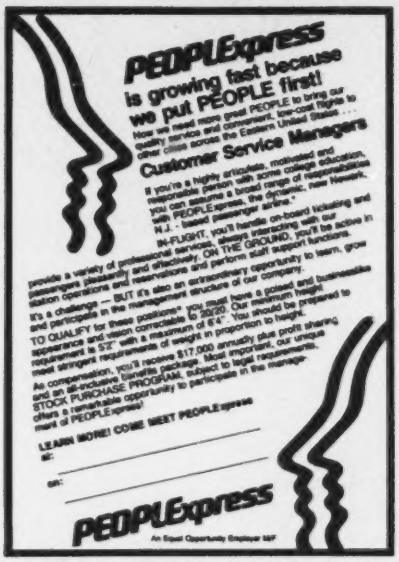
To Burr, air travel is "a commodity business, like chicken parts or steel. . . . Our strategy is to knock the price down so low that it fills the plane"—so low, in fact, that flying People Express will often be cheaper than driving or taking a bus.

bearing People Express's double-profile trademark accepted passengers bound for Columbus, Ohio; Buffalo; and, Norfolk, Va. George Rayl, who had just moved his wife and three children from California to Newark in a 24-foot U-Haul, was at the controls of the Columbus flight with 68 people on board. "There I was, a captain," he says, "something I'd always dreamed about. I couldn't have done it that fast anywhere else." Don Burr watched him take off, standing there transfixed in his white shirt, tie, and light gray business suit, working his face in wonder like a kid suddenly cut loose in a candy store.

For the price of their tickets, major commercial airlines generally offer inter-airline reservations support, reservation agents at the terminal, two classes of service, free baggage check-in and transfer, free soft drinks and meals, and free magazines. People Express looks at air travel from a radically different perspective in which all of the above are irrelevant. "It's a commodity business," says Burr, "like chicken parts or steel." Burr reasons that, given safety, a convenient flight schedule, and clean aircraft, the one thing passengers care most about is price.

"Our strategy," Burr says, "is to knock the price down so low that it fills the plane." So low, in fact, that flying People Express will often be cheaper than driving or taking a bus. Not only will habitual airline travelers panic for a seat, but folks who ordinarily would have used another form of transportation won't be able to control themselves either. "Fly smart," People Express ads urge travelers. If there is any doubt that he is on the right track, Burr simply points to the incontrovertible evidence of the 83.6% load factor.

Of course, popularity doesn't necessarily mean profitability. Many a plane has taken off packed to the baggage compartments only to land in red ink. The load factor is just one of three variables that must be handled with surgical dexterity if the airline is to make a profit. The other variables are revenue per passenger mile and costs per available seat mile, both of which resemble the revenue and cost-of-goods-sold components in a manufacturing company. The lower the costs, the less an airline has to charge the customer, and the lower its break-even load factor. In 1982, People Express's cost per available seat mile of 5¢ was the lowest in the industry. Thus, the company could maintain its deep discount pricing, charging travelers as little as 8¢ per passenger mile and still make money. At those levels, only 60% of all available seats had to be filled to break even.



It is noteworthy that during the first six months of 1983, the actual load factor had risen faster than the break-even load factor because roughly 95% of every sales dollar at load factors above break even goes to the bottom line. "Guys like Eastern and Delta," McAdoo says, "if they're in the same market elbow-to-elbow against us trying to match our standard fare of 8¢ a mile, have to be absolutely full to break even. They've got to sell every seat or they'll lose their shirts, because it costs them 8¢ a mile to produce a seat. And somebody like US Air, if they're matching that 8¢ fare of ours can sell every seat and still not make it, because they can't cover their costs."

When Burr talks about the company's extraordinary success in controlling costs, he attributes it first to a state of mind, an attitude shared by everyone in the company that rejects waste, and secondarily to specific operating tactics. After years of experience, he explains, it is relatively easy to predict that by tearing out the first-class and galley sections on a 737, People Express could increase the number of coach-class seats from 90 to 118. Or that by innovative scheduling, it could keep the planes in the air longer—10.4 hours per plane per day versus an industry average of 7.12 hours per day. Or that by eliminating unnecessary free services it would save money. "But without the wholehearted, personal commitment of everyone involved," he says, "you could do all of those things all day and still fall on your face. That's why we thought longer and harder about building our people structure here than we did anything else."

As hokey as the term may sound, the so-called people structure has the drawing power of last call at a Saturday night beer blast. When People Express interviewers come to town looking for customer-service managers, hundreds, even thousands, of people show up. Only one applicant out of every hundred is hired. "The hiring process is extremely important," Lori Dubose says, "and it gets a lot of attention."

People Express hires for three categories: flight managers, another way of saying pilots; maintenance managers, who concern themselves with the physical well-being of aircraft; and customer-service managers, who do just about everything else, including such in-flight functions as baggage check-in and reservations and such staff functions as accounting. It should be noted, however, that with the company's program of cross-utilization, no employee does the same job all of the time. Every applicant in any category must first survive the jaws of an extensive screening before he or she is even offered the chance to attend training classes, which is not to be confused with a job offer, which it isn't.

Recruiters spend about five hours evaluating each individual's qualifications. They are looking for the right People Express "type," and they know exactly what they want. Seen in groups of five or six at the Holiday Inn North or the Howard Johnson Motor Lodge, customer-service managers-in-training shine with a clean-cut, collegiate exuberance and a pleasant, if predictable, homogeneity. According to Dubose, this collage of personal attributes creates a memorable atmosphere of enthusiasm, confidence, and competence that keeps passengers flying People Express.

Hoards of people fall all over themselves for a chance to get grilled to a turn and live in a Holiday Inn during five weeks of training. If they win, they win big. By the end of their first year, customer-service managers draw a base pay of $19,500, but since the company offers not one, but two, profit-sharing plans, they can receive an additional 15% of base pay. And while they are busy filling out deposit slips, they are protected by 100% medical and dental coverage. "We just didn't want them to have to worry about it," Burr says.

Then, of course, there is the stock. Every employee is required to own stock in People Express. Customer-service managers must purchase, as a condition of their employment, 100 shares at prices far below the market. If they aren't able to afford it, the company gives them an interest-free loan. Since additional buying opportunities are made available throughout the year, employees generally end up with a significant investment. According to Dawsey, each employee owns an average of

The people structure at People Express has the drawing power of last call at a Saturday night beer blast. When the interviewers come to town looking for customer-service managers, hundreds, even thousands, of people show up.

John Goodman

Burr (top) was overjoyed after getting CAB permission to form a new airline. Melrose Dawsey (left), Hap Pareti, Bob McAdoo, and Lori Dubose (photo right, left to right) left Texas International to join him at People Express.

Jim Wehrenberg/Photo Star

2,500 shares worth about $46,000 at today's prices. "We're not sitting around here counting roses," asserts Burr. "This is capitalism. People are getting rich here. There are millionaires walking around here and tons of 24- and 25-year-olds worth $75,000, $100,000, $200,000. Tons of 'em. The only way I know to wealth in the long term is to own a piece of something and build it."

The early dreams of growth and wealth were sweet and full, and exceedingly fragile. Only three months after the first flights took off, it suddenly appeared that Burr's "piece of something" would never be anything more than a piece of wreckage. People Express faced ruin. On August 3, 1981, members of the Professional Air Traffic Controllers Organization (PATCO) went out on strike. The Federal Aviation Administration sharply reduced flights at 22 airports throughout the country, including Newark. People Express, which had seven planes and 35 departures a day from Newark, was cut back a full 35%. Burr estimates that from August to October, the company lost $6 million from canceled trips and low load factors. In addition, the company was rapidly reaching the point at which it could no longer live up to the conditions of its agreement with Lufthansa. If it didn't have the cash to continue buying planes, the company would lose the $6-million deposit with Lufthansa. "We were bleeding at a terrific rate," says Burr. "It was gun-to-head time. We were going out of business."

Burr and his colleagues decided on a desperate strategy. They would fly planes out of Newark to Buffalo, Columbus, and Baltimore, all uncongested and unrestricted airports. Then they hoped to fly back and forth to Sarasota and West Palm Beach, Fla., bypassing Newark. But the company's research had failed to indicate whether there was much of a market for such flights. When the planes took off on October 25, no one even knew if there would be enough passengers to pay for the gas. What is more, this shot-in-the-dark meant the company had to abandon its original hub-and-spoke operation, which in turn meant that new support services, such as maintenance and commissary supply, had to be established. "We had to bet the company a second time," Burr says. "Who'd ever heard of a 'bypass' strategy? Nobody had ever done that before. We had to create a whole new airline and we had to do it overnight."

McAdoo says the company chose south Florida on the chance that it was the one destination that, with its leisure-time attraction, might prove especially sensitive to price. "At $59," he says, "we thought it was cheap enough that people might take trips out of the clear blue saying, 'Why shouldn't I go to Florida?' or 'Why shouldn't I go twice instead of once, like I usually do?' "

Once again, People Express bet right. People did ask those questions and they did fly. The sunshine and warm waters of south Florida were too much to pass up in the winter of 1981–82. The planes started out 60% full but quickly built up to a load factor of 85% on many of the routes. And out of it, the company squeezed enough money to stay alive. As flight restrictions were lifted, People Express gradually returned to its original blueprint.

To Burr, building an enterprise is building the people within it. In his view, the people *are* the enterprise. Most companies, he argues, organize themselves around structures and policies that force employees to serve the company. The traditional, corporate pyramid of authority, for example, with its ascending layers of supervisory control, smothers individual initiative. Many companies contain the unspoken prejudice that employees are unreliable or, as Burr puts it, "guilty until proven innocent." Nor does this attitude go unnoticed by the employee. In time, it spawns indifference, disaffection, even belligerence. Better, Burr reasoned as far back as the dream-time days in Houston, that a company be organized to serve each employee individually by giving ownership, direct participation in its affairs, the freedom to fashion a personal contribution, and an opportunity for personal growth. People Express is an experiment to that end, an attempt to create an environment in which the usual distinctions between the company and the employee are no longer relevant, because the two have become one.

In addition to ownership, the most conspicuous features of the People Express "environment" include a relatively "flat" management configuration, the use of teams, self-management, and cross-utilization. According to Richard Hackman, a professor of organizational behavior and psychology at Yale University and a consultant to People Express, the company is traveling in uncharted territory: "Other firms have done parts of what they're doing, but the complete package is unique. They're trying to invent a new way of organizing and managing the human resources of the firm."

Work at People Express is first separated

In Burr's view, the people are the enterprise. People Express is an attempt to create an environment in which the usual distinctions between the company and the employee are no longer relevant, because the two have become one.

Jim Nachtwey/Black Star

On May 26, 1983, the first People Express flight from Newark to London took off. Waiting for the London flight has since become a spectacle in its own right, a mark of the veteran traveler.

into four "umbrella" categories: people, finance and administration, marketing, and operations, and then into 13 specific functions, as opposed to the "staff" functions, such as accounting, administration, and scheduling necessary to run the company. Although everyone at People Express is a "manager," there are distinct gradations in authority and leadership. Six managing officers provide general direction and leadership in each functional area. Team managers, a more recent addition to the People Express lineup, serve as liaisons between the teams working in any given area and the managing officers and general managers. Customer-service managers, flight managers, and maintenance managers are expected to manage themselves by setting their own goals in keeping with the company's professed objective. The buck stops at Burr.

People Express has not tried to eliminate supervisory intervention but rather to minimize it. Further, Burr says, they have redefined it. Effective managers, he says, offer direction and make sure that the right information and tools are available to get a job done. They do not dictate methods nor do they police efforts. Actual performance is a matter of individual creativity. Burr points out, however, that People Express is not built on anarchy. The direction of the company is not up for grabs. "If you don't agree with that direction," he says, "you shouldn't be here."

Although it had existed in the collective mind of the start-up team, People Express's direction wasn't written down until December 1981. Eight months after the first flights, Burr convened a meeting of the team in the former VIP Lounge just off the main concourse in the North Terminal. He was concerned that the company's objectives might be lost among the daily distractions of a rapidly growing business. The meeting was recalled by everyone involved as a day of intense, argumentative debate. Burr asked each member in turn for his or her idea of what People Express was trying to accomplish. He wrote the answers on large sheets of paper and taped them to the walls. "They worked hard," he says. "I mean they put their blood on those walls." The team emerged with a list of six "precepts" that dedicated the company to "service, growth, and development of people"; becoming the "best provider of air transportation"; the "highest quality of management"; becoming a "role model"; "simplicity"; and the "maximization of profits."

To managers at People Express, each precept appears to reveal more amplified verities. For example, Burr will point to the first two precepts and explain that they can guide managers through the puckerbrush of daily affairs: "If it's good for a customer or good for a peer, the choice you want to make in any of the myriad decisions you're faced with each day is probably a good idea." Collectively, the precepts are meant to reveal the very soul of People Express.

The best method he has yet found to translate the precepts into action is by organizing all of the managers into teams of two or three members and by cross-utilization. Everyone in the company, including the managing officers, are members of a team. This design is thought to foster self-management and a highly productive esprit de corps while at the same time eliminating additional layers of supervisory control. Teams also participate in the decision- and policymaking of the company by electing members to advisory and coordinating councils, which meet with Burr, the managing officers, and the general managers.

Cross-utilization is also considered a vital method of honing the company's competitive edge and an indispensable source of heightened productivity. Every month, a variable portion of each manager's time is devoted to some line function generally outside of his or her primary area of staff responsibility. Thus, Candee Brock, a team manager in accounting, gets to check in baggage, and Bob McAdoo, the managing officer for finance, is frequently seen serving drinks aboard a flight. Hackman, the company's consultant on organizational behavior, sees cross-utilization as a "trade-off." He says it requires more time and money in training, and that even then there are problems in maintaining operational continuity because people are moving into areas in which they are not yet fully expert. "On the other hand," he says, "you get people who really understand the business because they're not penned into a particular function."

If People Express's operating results don't prove the success of the people structure, there are two additional facts that may help. First of all, People Express has no unions. The Air Line Pilots Association International tried twice and failed. There was no interest. "Unions have a place in American business," Hap Pareti says, "but that place exists only where their role is important to protect the employees against actions of an employer who doesn't have the employees' interest in mind. To the extent you structure an organization that literally spends the majority, if not the total, amount of its time dedicated to workingowith its people, you don't need a union." Jack Blake, 33, a former Navy pilot who joined People Express two years ago, says that although he could probably double his $36,000 base salary at another airline, he intends to stay put. "I'm happy where I am," he says. "I've got stock and security. Last year I made captain. With the seniority systems at other airlines, I might never have gotten the chance." Finally, there is the plain fact that during the first quarter of 1983, passenger miles per employee was twice that

The London connection had long been regarded as the jewel of international routes. The load factors on existing flights were already attractive, but People Express sweetened the pot a little more by offering a $149 one-way ticket.

of the industry average for full year 1982.

But Burr still isn't satisfied. He says the company's people structure is only "60% successful," and points to problems in getting managers involved in the company's decision- and policymaking processes. "It's horribly difficult to give everyone a sense of commitment and participation," he says. "It's an inch-by-inch, every day, grinding process. There's no magic, no wands." The organization report prepared in 1982 had already identified several areas that needed improvement, including "meaningful staff work with built-in feedback, clarity about authority and constraints, built-in accountability, individual recognition, and available leadership." The report traced many of the problems to the "small number of designated leaders at People Express." It said: "This leadership element can no longer adequately address the requirements . . . for an entity of nearly 1,000 managers." The subsequent introduction of the team-manager concept to expand the company's leadership is fairly typical of the continuous evolution at work within the people structure. Jim Miller, team manager for management development, says that there are now 85 team managers and that the concept has "worked out very well."

As real as these problems may be, they are difficult to spot from any vantage point outside the company. Once the PATCO crisis had passed, People Express settled into its now familiar pattern of meteoric growth—buying more planes, hauling ever more passengers, and generally living up to its reputation as a bona fide business phenomenon.

Gerry Gitner, one of the founders and, at the time, president of the company, resigned early in 1982 to become executive vice-president for finance at Pan American World Airways Inc. According to Burr, Gitner "just never got comfortable with the basic direction of the company." "He did not believe," Burr says, "in the strength, the direction of the precepts. He was much more oriented toward routes and planes and tell people what to do, don't get in there and discuss it with them. The competitive business strategy that I doped out, which relies on enabling the individual to do well, he just couldn't get comfortable with. He didn't believe it. He said it was a pipe dream. I was disappointed when he left. I felt like I had lost a guy that I had tried hard to convince and I didn't make it with him."

Gitner had decided that the job at Pan Am was even more challenging than the presidency of People Express. In a prepared statement, he described his reasons for leaving People Express as follows: "The opportunity was presented to me to participate in a major fashion in the attempted turnaround of a world-class company. The ability to confront new and exciting challenges in this kind of situation was too tempting to resist. I felt that the goal-setting and business plans that I had developed at People Express were on sufficiently firm ground that I could begin my work at Pan Am."

But not even the departure of its president could slow the company's momentum. The fledgling airline was rapidly becoming an institution, so much so that the distinguished investment banking firm of Morgan Stanley & Co. joined Hambrecht & Quist in a second public offering of People Express stock in August 1982. It looked as though the days of corporate derring-do were gone for good. Then Hap Pareti went to London.

The London connection had long been regarded as the jewel of international routes. Although that city was a popular destination in its own right, it also served as a major departure point for more extensive European tours. The load factors on existing flights were already attractive, but People Express thought it might sweeten the pot a little more by offering a one-way ticket priced at $149, well below prevailing prices.

On April 6, 1983, shortly after the CAB approved the company's application, Pareti arrived in London to petition the British Civil Aviation Authority and the Department of Trade. He spent the next two days giving presentations. By the middle of May, Pareti still hadn't gotten any indication of British intent. He was concerned that his application had somehow become entangled in the arguments between the United States and Great Britain over the resolution of the recent Laker Airways bankruptcy. Pareti returned to London to dynamite the log jam.

On May 20, Pareti called a press conference at The American Club in London to announce that even though People Express had not yet received official approval, on May 23 it would begin taking reservations for the first scheduled departures from Newark on May 26. "When I walked into that room," Pareti says, "there must have been 100 people from the press there and 15 microphones sticking out from the speaker's platform and I was thinking to myself, Oh God, Hap, what have you done now?" The next day, the London papers announced the story on their front pages, with *The Times* proclaiming, "Flying Start for People Express." The news was released simultaneously in the United States, and within 24 hours every flight in both directions was booked solid for the next two months.

The first flight was scheduled to take off from Newark at 7:15 p.m. on May 26. At 6 o'clock that morning, Pareti, who had been up most of the night with his infant son, Jonathan, finally got the call from the British authorities giving him the approval he needed.

Waiting for the London flight has since become a spectacle in its own right, a rite of passage, a mark of the veteran traveler. The daily drama enacted before the check-in counters on the main concourse of the North Terminal is perhaps the single most convincing demonstration of the magic of People Express's strategy. A thick crowd of well over 200 people churns around in a sea of knapsacks and baggage. Some sleep on bedrolls in the middle of the aisles. A family with three young children is playing cards on a blanket. Another group is sitting cross-legged on the floor eating pizza. When the 6:30 p.m. standby call is announced, all the standbys rise as one and turn reverentially toward the check-in counters as if the Second Coming has just been revealed. The looks of anguished expectancy, the whoops of joy, and the expletives of bad luck alone are worth a trip to Newark.

Some industry analysts worry that People Express may lose control of its growth. That the insatiable need for large numbers of qualified employees and an increasingly complex operation will eventually cause People Express to spring a leak somewhere. But Don Burr isn't worried. A similar concern was recently expressed by 1 of some 35 newly hired flight managers attending an indoctrination meeting, and Burr said, "Look at IBM, they've got 370,000 people. They're very successful, aren't they? Beautifully managed, aren't they? Still an incredible entity, right? I don't see any natural boundaries to our growth." Nor is Bob McAdoo concerned. "It's going to continue to be tough," he says, "but the toughest part is behind us." McAdoo says the company is planning on a long-term growth rate that averages out to adding one and a half to two planes per month and predicts that revenues will "hit a billion dollars in a couple years."

Candee Brock won't be surprised. After all, she has always known that she was part of a "very successful airline." But today, sitting here in accounting, she still marvels at the wonder of it all. "It was strange," she says. "I wasn't really looking for a job. I was going to college. But there was something about that ad that seemed to say, 'Candee, this might be for you.' "□

Some industry analysts fear People Express may lose control of its growth, but Burr isn't worried. "Look at IBM. They're very successful, aren't they? Beautifully managed, aren't they? I don't see any natural boundaries to our growth."

INC. Special Report

By Donna Sammons

ACCOUNTING FOR GROWTH

Accounting firms, large and small, are battling for the business of small business. What do these firms really have to offer?

In 1977, when Heath L. Kline, chief executive officer of Priority One Electronics, hired Neal Elias, the head of a small certified public accounting firm, he thought he had his accounting problems licked. Elias would provide Priority One, a wholesale distributor of computer components in Chatsworth, Calif., with tax, auditing, and accounting services, as well as act as an all-purpose business adviser. But with Priority One's sales growing at more than 134% compounded annually, the job became too much for one man to handle. So, in 1983, Kline decided to hire another accounting firm to help out. The only question was, which one?

Letters were sent out to Big Eight accounting firms, asking if they had any interest in serving Priority One. Although Kline knew the Big Eight firms were courting smaller companies, he was surprised by the intensity of their response.

"They wanted us, and they let us know they wanted us," Kline remembers. "Immediately, they called and asked, 'Can we get to you today? Tomorrow?' They inundated us with booklets, then told us this was just the beginning of what they could provide. They spent hours learning about our particular business, then talked with me in person. They asked us if we had questions, then called to see if we had more questions." In the end, Kline settled on Arthur Young & Co. "They called the most often—as late as 10 p.m.," Kline says. "It's their persistence that did it."

Ten years ago, such dogged pursuit of a small company's business by Big Eight accounting firms was unusual, despite the fact that, under the American Institute of Certified Public Accountants Code of Professional Ethics, CPA firms could respond to inquiries from prospective clients. Direct solicitation *was* prohibited, but that part of the hallowed canon is kaput, thanks to a 1977 U.S. Supreme Court ruling that allows professional service firms to advertise. The present AICPA code permits CPAs to make cold calls on prospective clients, conduct direct-mail campaigns, and even take out ads in newspapers and magazines.

In short, accounting firms are now doing what other businesses have been doing for years—competing. They are pressing the flesh, engaging in price wars, trying to out-razzle-dazzle each other. Out are the green eyeshades. In are words like "marketing," "targeting," and even, in certain circles, "penetration." As Richard A. Connor Jr., of CPA Marketing Systems (a division of Synergy Corp.), a consulting firm in Springfield, Va., says, "Some of these firms are real piranhas."

With their new-found aggressiveness, the accounting firms hope to gain a chunk of the small business market—something they considered "small change" just a few years ago. "The Big Eight," Connor says, "knows what it's looking for—tomorrow's Apple, Xerox, or IBM."

And to find them, they're going to great lengths, as the case of Deloitte Haskins & Sells's hot pursuit of Catalyst Technologies Inc., in Sunnyvale, Calif., illustrates. About two years ago, Jack Peth, the partner in charge of small-business services for Deloitte in San Jose, Calif., heard about Catalyst, a company that nurtures start-ups by providing them with centralized financial and clerical services for 6 to 18 months. After that, they strike out on their own. Great idea, Peth thought. Great source of new clients, his colleagues at Deloitte agreed.

Landing the Catalyst contract became, for Peth, a mission. His first step was to meet with John Anderson, Catalyst's executive vice-president, then with Nolan Bushnell, the corporation's founder and owner. Would those two men consider hiring just one accounting firm to serve all the companies under Catalyst's wing? Peth wanted to know. They would, Anderson and Bushnell responded. So Peth set out to assemble an "engagement team," Deloitte's version of a strike force.

"We had two tax people, two or three small-business department personnel, a management consultant, all the people we thought we would need to be responsive to Catalyst's management," Peth recalls. "We wanted to have enough contact with them, [because] we knew they weren't going to make a decision in a one- or two-hour meeting."

On that point, he was correct. It took Catalyst three months to decide to hire Deloitte. Before the search was over, Catalyst's management had spoken with each of the Big Eight firms, including Arthur Young, which handles Nolan Bushnell's personal finances, and Peat, Marwick, Mitchell & Co., which serves another of Bushnell's companies, Pizza Time Theatre Inc.

But Deloitte hung in. Its CPAs conducted lengthy meetings with Catalyst's management, quoted a fee below its normal rates (it won't say how much), and offered an "on site approach." This included establishing a permanent office at Catalyst's Sunnyvale facility, with a Deloitte staff member present several days a week.

What is happening with the Fortune 1,000 is what I call zero sum growth. Their clients aren't growing, so the accounting firms aren't getting anywhere, either. They need small business.

—Richard A. Connor Jr. of CPA Marketing Systems

Why go to such lengths for a single company—even one with the potential of generating additional business? Accounting firms, particularly the Big Eight, *have* to. After years of kowtowing to the largest corporations, the Big Eight is finding it hard to expand. "What is happening with the *Fortune* 1,000 is what I call zero sum growth," says Connor of CPA Marketing Systems. "The accounting firms—because their clients aren't growing—aren't getting anywhere, either. They need small business."

Connor isn't talking out of school. The Big Eight admits they have a problem. "We're not going to increase our chargeable hours by trading *Fortune* 500 companies," says Howard Miller, Peat Marwick's national partner in charge of Private Business Advisory Services, echoing the sentiments of his peers. "The only way we're going to increase our chargeable hours is to have more clients, and clients that are growing."

But local, regional, and Second Tier firms need the business of small business, too. "In the state of Virginia in 1982," says Connor, "owner net income dropped or leveled off in roughly 70% of the accounting firms. It's getting critical out there."

That is bad news for accountants, certainly, but it is good news for smaller companies. The reason? The stiff competition is having the same effect on accounting as it has on other industries. It is producing improved service, and it is prompting good old-fashioned rate wars. In short, small businesses can now demand—and get—more attention from their accountants. And they can, if they are in the market for a new CPA, be courted by the country's most prominent firms. "The biggest benefit from all the increased competition," says Robert Owen, the partner in charge of Arthur Young's Entrepreneurial Services Group, "is that small companies have been educated to the fact that there are tremendous resources available at a reasonable cost."

Traditionally, small companies regarded small CPA firms as their accountants of choice, but no more. "In the old days," says Catalyst's Anderson, "if you started a new company, you used the CPA firm you always used. Now firms have to bid for your business and make a strong effort to keep it. It's a lot tougher for them now. They have to continue to sell and prove themselves."

Touting their new "small business teams" is one way the Big Eight are selling themselves to small companies. Touche Ross & Co. ballyhoos its Private Companies Advisory Services Group. Coopers & Lybrand talks up its Emerging Business Services, and Price Waterhouse trumpets its Comprehensive Professional Services. At Peat Marwick, the emphasis is on Private Business Advisory Services, and at Arthur Young, it is the Entrepreneurial Services Group. The names of the Big Eight's small-business teams may differ, but, in truth, they are all the same.

Local, regional, and Second Tier firms, on the other hand, don't have small-business departments. They don't need them, they insist, because their entire practice is at small business's beck and call. But, like the Big Eight, they have jumped into the promotional fray to get small companies' attention. One firm, Kennedy/Chaintreuil & Bailey in Rochester, N.Y., has even offered clients free use of its paper shredder (12 takers, so far).

The list of tools most accounting firms now use to court small companies reads like a page from Marketing 101—surveys, speeches, seminars, direct selling, brochures, newsletters, and advertising. Much of the advertising to date has been "institutional," geared to improve name recognition. But some ads are quite specific. Oppenheim, Appel, Dixon & Co. in New York City, for instance, wants to be known as the accountant of the financial services companies, and it advertises accordingly. "When it comes to the securities and brokerage industries," the firm said in a recent ad, "OAD's a guiding principal. We do more work and have more top people in these industries than any comparable firm."

An equally straightforward approach is taken by Clifton, Gunderson & Co. Shortly after opening an office in Chicago, it took out an ad in a regional business publication, saying, "Should your business be making more money? Our management advisory services team can help. . . . An operational review can identify weaknesses in your organization and provide assistance to maximize effectiveness and efficiency and, as a result, improve profitability."

In Alexander Grant & Co.'s new ads, the firm promises to turn small companies' bookkeeping departments into profit centers with its new microcomputer system. One of the ads has a picture of a darkened building with a lone office's windows lit. Inside stands a weary executive. "It's 10 p.m.," the ad states. "Unfortunately, you do know where your controller is."

There is no hard evidence that small companies sign on with a given firm because of its advertisements, brochures, or seminars. But in the hope that there is a correlation, accounting firms are pumping hundreds of thousands of dollars into marketing efforts. Coopers & Lybrand publishes *Emerging Business: Washington Newsletter* and *Executive Alert Newsletter*, two monthly publications aimed at the small-business market. Ernst & Whinney publishes *Ideas*, a semiannual magazine for the "owner/manager" of privately owned businesses, and Touche Ross has *Private Companies Review*, a newsletter published bimonthly. Arthur Andersen & Co.'s monthly publication for closely held businesses, *The Insider*, competes with Main Hurdman's bimonthly *Executive Action Report*.

With its seminars, Touche Ross is teaching small companies "money-making, money-saving strategies that can be put to work immediately," says Harvey Braun, national director of client services and development. Two examples, he says, are the conferences the firm held last year in Rochester, N.Y., and Houston. Their purpose was to show business how to apply for a $50,000 grant through the Small Business Innovation Research Act of 1982.

Kamanitz, Freiman & Uhlfelder in Baltimore sponsors seminars, one of which is designed to acquaint clients' spouses with tax, financial, and estate planning. Fox & Co. is reaching out with its workshops to the increasingly large market of women professionals. It is also co-sponsoring seminars with brokerage houses and regional banks on tax and finance topics.

For all the accounting firms' hoopla in going after small business's business, however, the services the large CPA firms provide aren't that different from those offered by smaller firms. And there is a reason. Accountants are a homogeneous group. They make their livings following "Generally Accepted Accounting Princi-

With the two smaller firms [we had previously employed], we spent all our time teaching them. With the larger firm, we get advice, feedback. The Big Eight can compare us with others.

—Patti McVay of Fifth Season Travel

John Starkey/Black Star

ples," and that, by itself, precludes much individuality. As John A. Thompson, Main Hurdman's managing partner and CEO, notes, "We sell a generic product."

What the Big Eight accounting firms, as a group, offer small growth companies are contacts—contacts with underwriters, bankers, and venture capitalists. When a company goes public, most underwriters insist that it hire a Big Eight accounting firm to audit its financial statements—even if, like Telecommunications Specialists Inc., based in Houston, it doesn't want to. "But we're no fools," says Robert Resnick, president and CEO of the $24-million-a-year company. "If it'll help us appeal to investors, we'll have to spend the additional money to secure a Big Eight."

The Big Eight, many people claim, has an "in" with the Securities and Exchange Commission. "The SEC will deny it, I'm sure," says M. William Benedetto, executive vice-president and manager of corporate finance for Dean Witter Reynolds Inc., in New York City, "but, yes, processing is quicker with a Big Eight."

Nonsense, says the SEC. "If a small company asks, 'Do we need a Big Eight or a Second Tier firm to go public?' " William Wood, associate director of the SEC's Division of Corporate Finance in Washington, D.C., says, "our answer is no."

Underwriters also insist on large accounting firms for public stock offerings because, they say, a Big Eight name adds credibility to a company's financial statements. Insists Thomas I. Unterberg, chairman and senior managing director of L. F. Rothschild, Unterberg, Towbin, the Wall Street investment banker, "Big Eight instills confidence in investors."

Actually, a Big Eight firm instills confidence in *underwriters*. "To reduce uncertainty, you shoot for a large firm," says Bob Pangia, vice-president of Kidder, Peabody's technology group. A similar point is made by Michael Roberts, senior vice-president of Smith Barney Harris Upham, and Benedetto of Dean Witter. "The first question asked if something goes wrong is, 'Why didn't you go with the big guy?' " notes Roberts. "Frankly," says Benedetto, "I wish there was a way around this [Big Eight] orientation. But there's a legal risk. Without a Big Eight, we're more open to liability."

Underwriters, Benedetto points out, have reason to be squeamish. When they value a company, they use numbers provided by accounting firms. Mistakes by those firms can prompt investment bankers to sell the stock at the wrong price, and, for that, underwriters can be sued.

Like underwriters, bankers believe that Big Eight accounting firms add a stamp of integrity to a company's financial statements. Unlike underwriters, they don't insist on a Big Eight firm. "At first blush, it's nice to have a Big Eight firm, but a Second Tier firm is fine with me," says Daniel W. McLaughlin, a vice-president of Chase Manhattan Bank in New York. "It's when you get down to the three-person shops and 'home accountants' that I worry."

Whether a large national accounting firm can improve a company's relationship with its bank depends, in part, on where that corporation is located and the size of its lending institution. "Our loan limit to any individual customer is $5 million," notes Hal Dumler, vice-president of The First National Bank of Topeka, Kans. In his mind, a company applying for that size loan doesn't need a national accounting firm.

But some bankers, like those at Chase Manhattan, actually go out and meet their clients' accountants. "We want to know if they do more than just minimal Generally Accepted Accounting Principles," says McLaughlin of Chase Manhattan. "Do they indeed go through the inventory? These are questions we ask."

National accounting firms' influence with banks varies by the lending institution. Some banks look to accounting firms for referrals and maintain close ties with them, others don't. First Federal of Pittsburgh estimates that 15% of its referrals come from accountants. On the other side of the coin, Don Stout, senior vice-president of the banking operation division of Georgia Federal Bank in Atlanta, insists, "We don't expect accounting firms to refer clients to us."

With venture capitalists, it is a different story. They do expect accountants to refer businesspeople to them. "There's a very definite symbiotic relationship between venture capitalists and the accounting firms," says Rodney L. Goldstein, a partner in Frontenac Venture Co. in Chicago. "We tend, as an industry," he adds, "to take very little for granted. If we know someone or some firm is good, that feels better."

What that means, of course, is that venture capitalists prefer to work with big-name firms. "A company should go first class all the way," says C. Richard Kramlich, managing partner of New Enterprise Associates, a venture capital firm in San Francisco. "First class means the Big Eight."

But venture capitalists don't always insist that their clients employ the largest accounting firms. "We don't push for any one type of firm," says Charles Coulter, president of American Research and Development, a Boston venture capital firm. "We recognize the value of a Big Eight and a Second Tier, but we want our clients to get good value for their money." In fact, about half of the companies American Research funds employ Big Eight accountants.

One corporation that kept its regional firm did so only after convincing its venture capitalists, Frontenac Venture and Golder Thoma & Co., that the CPA had "industry specific" information. "I think it's a damn shame," says Marcus Kostolich, CEO of Bulk Logistics Inc., a freight-forwarding company incorporated in Chicago in the summer of 1983, "that the smaller firms are discriminated against for doing good jobs for companies like us."

Another reason Kostolich's regional firm, Mueller, Hillsman & Co., won points from the venture capitalist was its relationship with Coopers & Lybrand. The regional accounting firm, as a rule, calls in Coopers when a project gets too big for it to handle.

The practice of small and large accounting firms working cooperatively on projects is growing more common. In Detroit, for example, Touche Ross has entered into an agreement with Rehmann, Robson, Osburn & Co. of Saginaw, Mich., to jointly provide tax, audit, and management consulting services to businesses in the mid-eastern region of Michigan's lower peninsula.

These arrangements make good sense for all parties involved. The national accounting firm provides the services that aren't available from the regional firm and, in that way, gains access to new clients. The regional firm, meanwhile, keeps its

The biggest benefit from all the increased competition is that small companies have been educated to the fact that there are tremendous resources available at a reasonable cost.

—Robert Owen of Arthur Young

client base stable and out of the clutches of the Big Eight, and small business is able to tap the expertise it needs without shifting to another firm. Bankers and venture capitalists like the idea, too. "There are a lot of businessmen who don't want a Big Eight, and we don't demand they get one," says McLaughlin of Chase Manhattan. "But to our smaller companies we say, look, keep your three-person shop, make them the internal accountants, then bring in Ernst & Whinney. Split your fee."

Fee, as might be expected, is another hot issue. Smaller accounting firms generally charge less than the Big Eight or Second Tier, but there are signs that the gap between the large and small firms' fees is narrowing. Kline of Priority One Electronics pays its local CPA more ($100 an hour) than it does Arthur Young ($80 an hour on average).

Almost all of the Big Eight firms concede that, to secure an account, they will "buy into" it, meaning they will provide accounting services at cut-rate prices, sometimes below cost. There are even reports of low-balling, although some firms, like Coopers & Lybrand, deny that they take part in the practice. "I've heard that for several years now," says Peter R. Scanlon, Coopers & Lybrand's chairman, of the rumor that his firm low-balls. "When you're successful, people have to find some way to take shots at you."

Scanlon may be right, but the price competition is real, and shopping around can result in real savings for small businesses. The CDX Corp. in Aurora, Colo., switched from Deloitte to Weiss Carr & Co., a local firm, and, in doing so, reduced its accounting bill by more than $5,000—with no noticeable decrease in the quality of services. The U.S. Mineral and Royalty Corp., in Oklahoma City, chopped its auditing bill in half when it dumped Arthur Young for a local firm, John L. Quaid in Wewoka, Okla. Edgewood Bancshares Inc., in Countryside, Ill., cut 25% to 30% from its accounting costs by switching from Peat Marwick to Deloitte.

Connor of CPA Marketing Systems recounts the case of a Big Eight firm that wanted a contract so desperately that it gave the audit away for $1 (it hopes to make up for its losses in management consulting fees). He also cites the experience of a small chemical company in Maryland. The company asked Big Eight accounting firms to submit bids for an audit. When the bids came in, they ranged from $3,700 to $12,700. The low bidder even offered free tax services.

Oddly enough, Maryland isn't even one of the areas where competition among accounting firms is especially tough. That list, says Richard A. Levine, national director of management consulting and marketing for Main Hurdman, includes New York City, Chicago, Boston, Seattle, Dallas, and, of course, Silicon Valley. In Dallas, the competition is so stiff that accounting firms are setting up shop in North Dallas, just 10 miles from their downtown offices.

The opening of additional offices is just another way the Big Eight and Second Tier are selling themselves to small business. The new facilities, they argue, enable them to "be closer" to small companies. In the past year alone, Peat Marwick branched out to three new locations. Ernst & Whinney, however, maintains the largest number of offices, with 112 locations (see table, page 82), followed by Deloitte (102), Peat Marwick (97), and Coopers & Lybrand (94). Main Hurdman, a Second Tier firm, ranks seventh in offices (84).

□

The one peculiar twist in the current competitive sweepstakes is that the Big Eight can't agree on a definition of small business. At Arthur Young and Ernst & Whinney, small companies have revenues of under $50 million. Price Waterhouse and Coopers & Lybrand, meanwhile, don't measure revenues at all. Instead, they look at the client's "service needs." The lack of a consensus definition, critics say, is a sign that the firms don't understand small companies.

Aside from that, small business's principal complaint about the Big Eight is that too much of the accounting work is performed by people fresh out of school. "The Big Eight," says McLaughlin of Chase Manhattan, "often sends out recent business school graduates" to serve clients. Comments Resnick of Telecommunications Specialists, "Using a Big Eight, we're a small fish in a big pond. And the work at a Big Eight is handled by associate people. You get textbook accounting. You're dealing with college graduates with three to five years of business experience."

Richard Thalheimer, president of The Sharper Image, a $100-million-a-year mail-order company in San Francisco, found this generalization alarmingly on target. "I walked into Price Waterhouse one day," he remembers, "and I saw one of the new accountants reading *Accounting Standards*. He had the book opened to the chapter entitled 'Inventory,' and he was reading the first sentence. I thought to myself, 'Why do I need to pay all this money for someone who is still reading his business right out of a book?' "

□

An accountant, the old joke has it, is someone hired by successful people to explain to the government how they did it. But, as many small companies know, CPA firms do more than correspond with the Internal Revenue Service. Accountants, as a rule, are the principal outside financial advisers of small business. Sometimes the advice accounting firms provide is good—as in the case of Century Industries Inc., a wholesale distributor of hardware and building products in Milwaukee. And sometimes it is bad, as the story of Fifth Season Travel Inc., in Indianapolis, illustrates.

When Bob Hillis became Century Industries's chief financial officer, he found that the company's books were a mess, so he hired Arthur Andersen to straighten them out. The firm ended up helping Hillis structure a leveraged buy-out and negotiate a way for the company to escape tax penalties that had accrued as a result of problems with its profit-sharing plan and state income taxes.

"It's safe to say we probably wouldn't exist today if it hadn't been for Arthur Andersen's help," says Hillis, now CEO of the $35-million-a-year company. "It cost a lot, that's for sure, but then it's worth the money when the life of your business is at stake."

Fifth Season Travel, on the other hand, didn't survive because of its accountants. It survived in spite of them. In 1977, when Patti McVay joined the financially troubled company, her two-man CPA firm was pessimistic about the future. "We were looking at how we might save the company," McVay remembers. "They were looking for graceful ways out."

So she hired another firm, but it, too, advised her to throw in the towel. McVay

GO PUBLIC, GO BIG EIGHT?

Norman Stavisky, a partner in the Boston accounting firm of Stavisky, Shapiro & Whyte, leaned back and laughed. "Look at that!" he said, nodding toward a dog-eared copy of *Time* magazine. On *Time*'s cover was a drawing of *Star Wars* archvillain Darth Vader. Across it was pasted the headline, "N. Stavisky Strikes Back!"

Clearly, someone admired Stavisky's chutzpah—and no wonder. In late June, Stavisky, Shapiro & Whyte did what few in the accounting profession have dared to do. The firm sued a Wall Street investment banker, Ladenberg, Thalmann & Co., over the loss of a client. It also sued the client, Kevlin Microwave Corp. in Woburn, Mass., for breach of contract.

Kevlin, a $6-million-a-year designer and manufacturer of microwave devices for radar systems, engaged Ladenberg Thalmann late last spring to underwrite an offering of its common stock. Then Ladenberg Thalmann instructed Kevlin to hire a big-name certified public accounting firm to audit the company's 1983 financial statements.

When Stavisky heard that Kevlin, his client since 1980, had retained Arthur Andersen & Co., he was livid. "James Galbraith hired me, and I want a letter from him telling me I'm fired and why," Stavisky told Kevlin Microwave's controller. In response, Galbraith, the corporation's chairman and chief executive officer, wrote, "It is with great regret that I inform you of [our] decision to change auditors. . . . We made this decision solely on the basis of underwriters' opinions that we must have a larger and more well-known accounting firm to express an opinion on our financial statements for our prospective public offering."

Galbraith's letter, delivered by messenger on June 6, did little to diffuse Stavisky's anger. In fact, it made him more furious. He decided—and his partners agreed—that he should contact the firm's attorney, William F. Macauley.

Later that week in Macauley's office, Stavisky recounted the tale of the lost client. Last spring, Stavisky explained, Kevlin began negotiating with investment bankers for an offering of its common stock. Stavisky, Shapiro & Whyte hoped that it would remain Kevlin's accounting firm and audit the corporation's 1983 financial statements.

However, Kevlin refused to sign an engagement letter (which is the equivalent of a contract) retaining Stavisky's firm for another year. It would not do so until Stavisky, Shapiro & Whyte was approved by the investment banking firm chosen to underwrite the stock. "I could understand that," Stavisky said later. "Sometimes an accounting firm is replaced by a Big Eight accounting firm during the time of an offering. Then the small accounting firm gets its client back."

Soon, Stavisky got word that he and his partners were being "checked out" by Burgess & Leith Inc., one of the underwriters with whom Kevlin was negotiating. Still, Stavisky thought, there was no need to worry. The worst that could happen, he reasoned, is that a large, national accounting firm might be brought in on a temporary assignment.

But even that fear dissipated quickly. Within a few weeks, Stavisky was told that Burgess & Leith had given his firm "high marks." Then, on May 4, Galbraith, Kevlin's chairman and CEO, signed the engagement letter retaining Stavisky, Shapiro & Whyte for another year.

With the letter in hand, Stavisky put his staff to work on Kevlin's audit. "We had people hopping," he remembered. Then the trouble began. In a brief telephone conversation on June 2, Stavisky was informed that Arthur Andersen was Kevlin's new accountant and auditor. Stavisky demanded a letter of explanation from Kevlin and got one, four days later.

What, Stavisky asked, did Macauley think of all this? "I have a very conservative attorney, and I really thought he was going to downplay it," Stavisky said of Macauley. "But he came back and told me and my partners that we had a prima facie case and that it was a wrong that should be addressed."

So, on June 28, Stavisky's accounting firm filed suit against Ladenberg Thalmann and Kevlin Microwave, seeking more than $10 million in damages from its ex-client and its ex-client's underwriter. The action, brought in Suffolk Superior Court in Boston, charges Ladenberg Thalmann with "malicious interference with Stavisky, Shapiro & Whyte's contractual and advantageous business relationships," and alleges that Kevlin Microwave breached its contract. The suit asks for a jury trial. So far, no date has been set.

What makes the Stavisky suit important is that it challenges underwriters that insist that companies switch to large, preferably Big Eight, CPA firms when they go public. The practice, accountants agree, is widespread.

Will the suit make a difference? Opinions on that score are divided.

Ed Malitsky

Norman Stavisky did what few would dare: His accounting firm sued a Wall Street investment banker over the loss of a client.

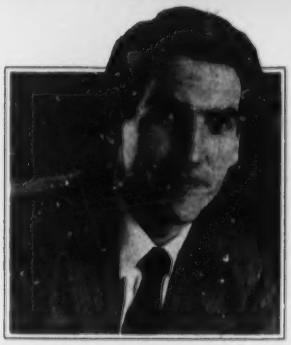
"Until the suit gets resolved, the fact of life is that if you're going to go public, or if you're going to go for big financing, 9 out of 10 banks are going to say go Big Eight, or the next two or three, the Main Hurdmans," says Richard A. Connor Jr., of CPA Marketing Systems in Springfield, Va. "This suit will make underwriters think twice before they insist on a Big Eight firm," counters Chuck Kaiser, the national managing partner of Pannell Kerr Forster, a Second Tier firm. "What will happen is that underwriters may look more at the professional qualifications of the auditor, rather than at the size of the auditor." He adds, "Big Eight auditors *are* bigger, but that doesn't mean they're better."

Kevlin Microwave and Ladenberg Thalmann, for their part, decline to comment on the case. As for Stavisky, he insists, "This is not a crusade for my profession. This is a matter of principle. If my clients don't like balding, chubby, Jewish accountants, they should have the right to change. But they shouldn't have the right to breach their contracts. And someone else shouldn't have the right to *get* them to breach their contracts."

Stavisky isn't alone in his thinking. Since the suit was filed last summer, the 48-year-old accountant has received a fair share of fan mail. Some people have even sent donations to help defray legal costs. Stavisky won't say how much he has received, but he notes that the smallest check was for $100.

I walked into Price Waterhouse one day and saw one of the new accountants reading Accounting Standards. *I thought to myself, Why do I need to pay all this money for someone who is still reading his business out of a book?*

— Richard Thalheimer of The Sharper Image



refused, and stuck to her strategy. Fifth Season Travel would prosper, she was convinced, by concentrating on business rather than vacation travel, and she was right. Today, the company's annual sales top $30 million, and it ranks third on the 1983 INC. 500 list of the country's fastest-growing privately held companies. As for accountants, Fifth Season has a new firm—Arthur Young.

"With the two smaller firms, we spent all our time teaching them," McVay explains. "With the larger firm, we get advice, feedback. The Big Eight can compare us with other travel agencies. They suggest operating forecasts and plans. They tell us to think about fringe benefits, better records filing, computers. An auditing firm," she adds, "can be more useful as a counselor than as an auditor." Resnick of Telecommunications Specialists agrees. "Auditing," he says, "could basically be done by a gorilla."

In the eyes of small business, what separates CPA firms is not the tax, accounting, and auditing work they perform, but the management advisory services they provide. When Kline of Priority One Electronics needed management people, Arthur Young provided assistance. Its headhunters delivered a handful of résumés. When Ted Fonk, president of Colorado Lace & Dry Cleaning Co., a 20-store chain in the Denver area, decided to purchase software for his microcomputer, he called in Alexander Grant to help him choose appropriate programs.

"The accounting firms," says Peter B. Wilkinson, a marketing management consultant for CPA firms in Paoli, Pa., "are going back to the original purpose of accounting, which was to help somebody run his business."

What should small companies expect from their CPAs? That they speak their language, not legal or tax jargon, that they provide timely and continuous attention, that they understand the company's business, and that they provide good advice, says Maurice J. Whalen, managing partner of the Washington, D.C., office of Fox & Co. To that list add personal involvement of the partners, assistance with banking relationships and with others in the financial community, personal financial planning, skills in business analysis and planning, and problem solving.

The competition for the business of small business is prompting the CPA firms to take note of the way they treat their small clients. And it is making it easier for small businesses to change CPA firms without bankers, venture capitalists, or underwriters suspecting that something is wrong. "Now, in the hustle for clients," says Pangia of Kidder, Peabody, "it's perfectly kosher to switch." □

Research assistance was provided by Susan Buchsbaum.

CONSULTING VS. AUDITING: HOW THE MAJORS RANK

	% of gross fees		
	Mgmt. advis. services	Accntg. & auditing	Tax
Arthur Andersen	27%	52%	21%
Pannell Kerr Forster	18	63	19
Laventhol & Horwath	17	62	21
Peat, Marwick, Mitchell	16	59	25
Ernst & Whinney	15	65	20
Coopers & Lybrand	14	66	20
Touche Ross	13	64	23
Kenneth Leventhal	12	62	27
Arthur Young	12	64	24
Price Waterhouse	12	67	21
Baird, Kurtz & Dobson	11	57	32
Alexander Grant	10	65	25
Deloitte Haskins & Sells	8	73	19
Clifton, Gunderson	5	61	34
Fox	4	65	31
Main Hurdman	4	69	27
McGladrey Hendrickson & Pullen	9	57	34
Seidman & Seidman	4	60	36
Cherry, Bekaert & Holland	2	71	27
Oppenheim, Appel, Dixon	2	55	43

Source: American Institute of Certified Public Accountants

WHO AUDITS THE INC. 500?

	No. of INC. 500 companies
Arthur Andersen	26
Coopers & Lybrand	22
Touche Ross	16
Deloitte Haskins & Sells	14
Price Waterhouse	13
Alexander Grant	13
Arthur Young	12
Peat, Marwick, Mitchell	12
Ernst & Whinney	11
Laventhol & Horwath	5
Main Hurdman	4
Pannell Kerr Forster	4
McGladrey Hendrickson & Pullen	2
Cherry, Bekaert & Holland	1
Seidman & Seidman	1
Big Eight	126
Second Tier	30
All others	344

Source: INC.

HOW THE ACCOUNTING FIRMS STACK UP

	No. of pros		No. of partners		No. of employees		No. of offices		No. of SEC clients	
Arthur Andersen	(1)	12,251	(2)	1,076	(1)	15,837	(10)	66	(1)	1,900
Peat, Marwick, Mitchell	(2)	9,905	(1)	1,284	(2)	12,200	(3)	97	(6)	919
Ernst & Whinney	(3)	8,320	(3)	1,058	(4)	10,620	(1)	112	(5)	961
Coopers & Lybrand	(4)	7,227	(4)	923	(3)	10,706	(4)	94	(4)	989
Price Waterhouse	(5)	7,000	(7)	629	(6)	8,500	(5)	87	(3)	1,005
Deloitte Haskins & Sells	(6)	6,350	(5)	794	(5)	8,794	(2)	102	(2)	1,466
Arthur Young	(7)	4,959	(6)	741	(7)	7,413	(6)	86	(8)	553
Touche Ross	(8)	4,680	(5)	794	(8)	7,085	(8)	81	(7)	723
Main Hurdman	(9)	2,242	(8)	523	(9)	3,506	(7)	84	(9)	219
Alexander Grant	(10)	1,645	(11)	340	(11)	2,485	(11)	60	(11)	180
Laventhol & Horwath	(11)	1,485	(10)	343	(10)	2,826	(14)	41	(10)	185
Pannell Kerr Forster	(12)	1,000	(14)	148	(14)	1,127	(15)	40	(17)	32
Fox	(13)	985	(12)	254	(13)	1,805	(12)	57	(12)	129
McGladrey Hendrickson & Pullen	(14)	930	(9)	412	(12)	2,049	(9)	78	(14)	52
Seidman & Seidman	(15)	662	(13)	176	(15)	1,117	(16)	37	(13)	62
Oppenheim, Appel, Dixon	(16)	437	(15)	77	(16)	747	(13)	52	(18)	25
Kenneth Leventhal	(17)	320	(18)	47	(17)	487	(19)	11	(15)	36
Clifton, Gunderson	(18)	225	(16)	60	(18)	400	(17)	23	(20)	4
Baird, Kurtz & Dobson	(19)	192	(17)	58	(19)	328	(18)	14	(19)	7
Mann Judd Landau	(20)	150	(19)	30	(20)	180	(20)	8	(16)	35

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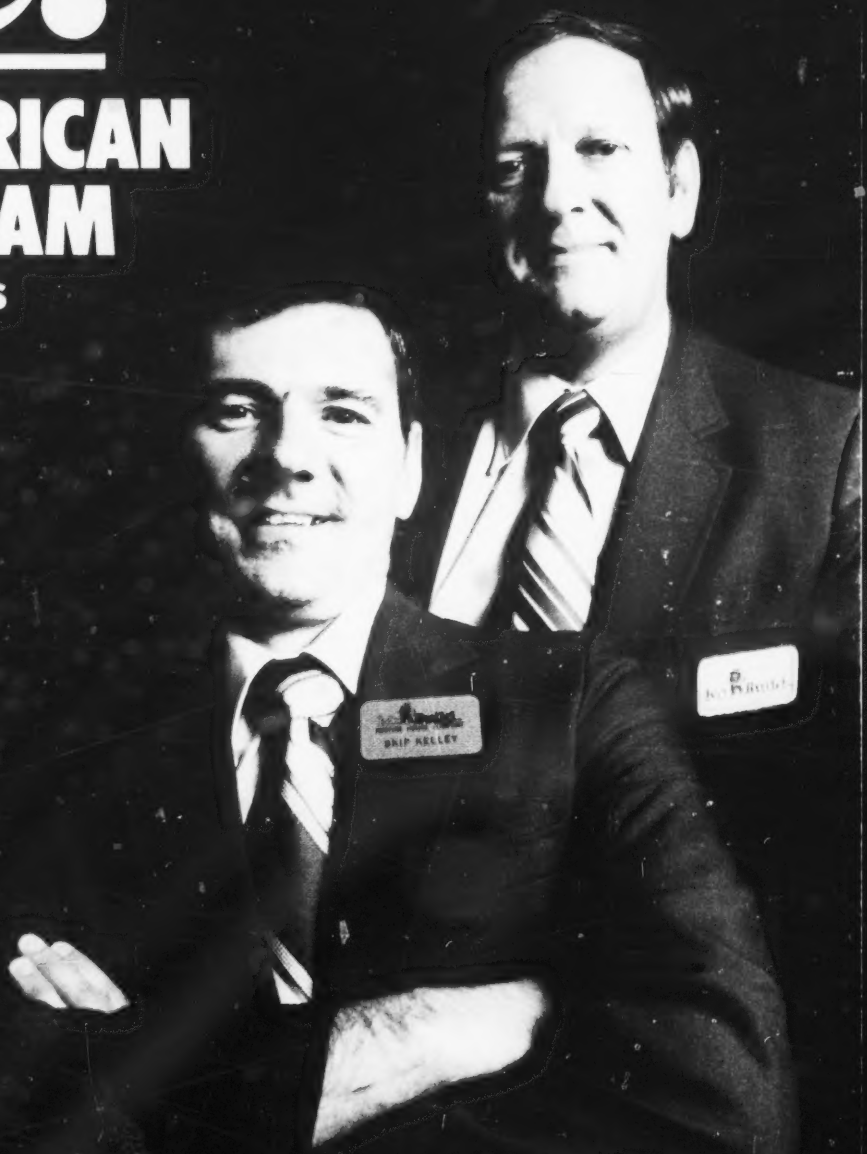

Art Bartlett, founder of the Century 21 and Mr. Build franchises; Skip Kelley (left), franchisee

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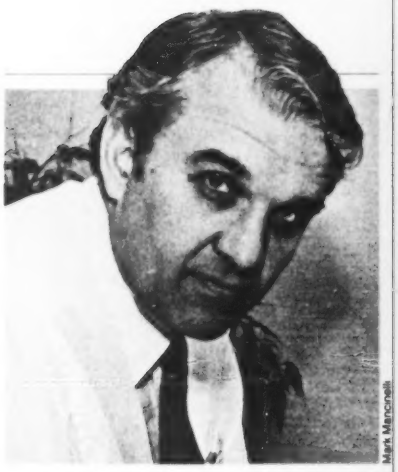

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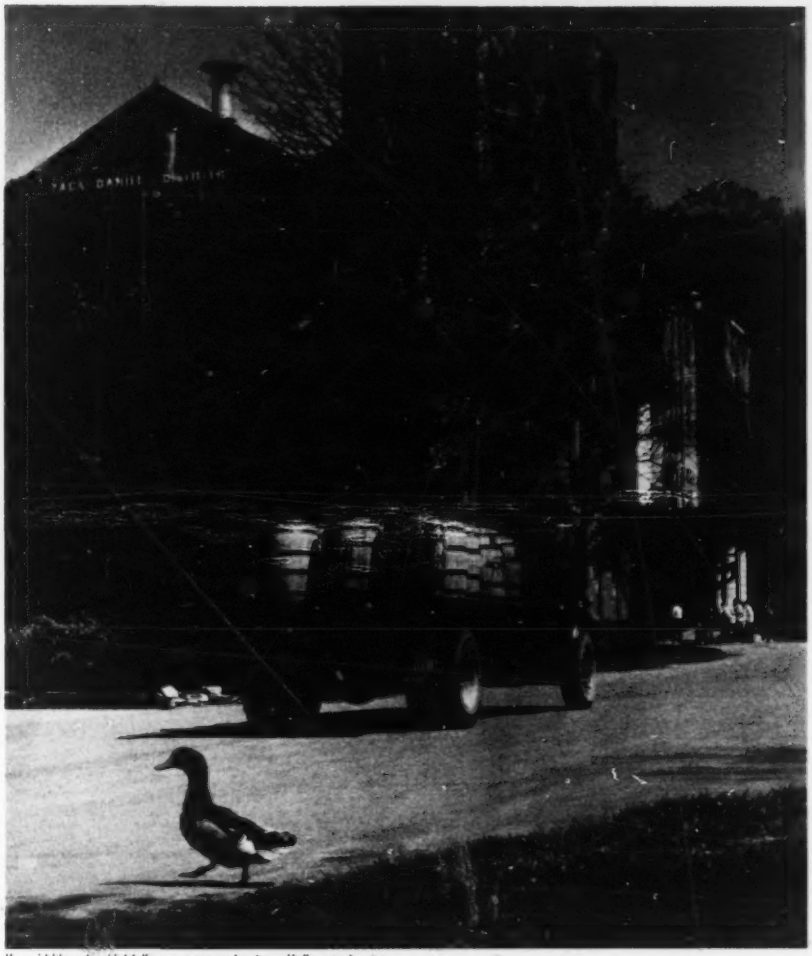

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SURPRISE! SURPRISE!

Roseann Schwaderer and Marion McGrath are mad as hell, but there is not much they can do about it. In January, their printing and typesetting company, Serif Press Inc., was socked with an unemployment-tax bill that included a surcharge of $693, and all because the company is located in Washington, D.C.

You see, the District of Columbia didn't have enough money to cover unemployment compensation claims, so it borrowed some from the federal government. The problem is, it did not pay the loan back in time. And it was not alone. Puerto Rico, the Virgin Islands, and 13 states also failed to repay their unemployment compensations loans by the November 9, 1983 due date.

Granted, the problems may have something to do with continued high unemployment, but some states—Connecticut, for example—have not repaid money they borrowed during the *previous* recession. All this adds up to a staggering debt of $11 billion owed by the 16 delinquent jurisdictions to Uncle Sam.

Upset about this state of affairs, the U.S. Department of Labor imposed a surcharge on employers in these jurisdictions. As a result, there were a lot of companies like Serif Press that found themselves with an unexpectedly large bill to pay in January 1984, when they mailed in their last quarterly unemployment tax form for 1983.

"To a business our size," notes Schwaderer, whose company has nine employees, "surprise costs are harsh. Whenever we get hit with taxes we aren't expecting, it makes it hard on us and our cash flow."

As it turns out, Washington, D.C., employers were the hardest hit, with a surcharge of $77 per employee. In Connecticut, Illinois, and Pennsylvania, the surcharge totaled $49 per worker, notes Eric J. Oxfeld, employee-benefits attorney for the U.S. Chamber of Commerce. In Kentucky, businesses got off relatively easy, paying just $21 a person.

Next year's surcharges may be even higher, says Oxfeld, since the 16 delinquent jurisdictions aren't likely to repay the entire debt this year. In addition, other states, whose loans aren't due until late 1984, may be added to the list.

Then again, some states have little to worry about, at least for the moment. Maine, for one, has repaid the money it owes the federal government. Its 1983 surcharge amounted to zero.

—Donna Sammons

WHO PAYS?

In January 1984, employers in 16 jurisdictions had to pay an unemployment tax surcharge for 1983. The 1984 surcharge will apply to employers in 22 jurisdictions.

	Extra unemployment tax per worker	
	1983	1984
Arkansas	$42	$63
Colorado	-	21
Connecticut	49	70
Delaware	42	63
Dist. of Columbia	77	98
Illinois	49	70
Iowa	-	21
Kentucky	21	42
Louisiana	-	21
Michigan	42	63
Minnesota	42	63
Missouri	-	21
New Jersey	42	63
Ohio	42	63
Pennsylvania	49	70
Puerto Rico	42	63
Rhode Island	42	63
Texas	-	21
Vermont	42	63
Virgin Islands	42	63
West Virginia	42	63
Wisconsin	-	21

Source: Eric J. Oxfeld, U.S. Chamber of Commerce.

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Ed McDonald
General Manager
Wavetek Indiana, Inc.
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